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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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| In the Matter of<br><br>Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992<br><br>Rate Regulation | MM Docket No. 92-266 |

VIACOM INTERNATIONAL INC.
<u>REPLY TO OPPOSITIONS TO PETITION FOR RECONSIDERATION</u>


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Viacom International Inc., by its attorneys and pursuant to Section 1.429 of the Commission's Rules, hereby replies to the oppositions to its Petition for Reconsideration and Clarification of the Commission's Report and Order in this proceeding.[1]

## I. INTRODUCTION

In its Petition, Viacom submitted an economic analysis, prepared by Dr. James N. Dertouzos and Dr. Steven S. Wildman,[2] which identified serious errors in the methodology used to calculate benchmark rates. Specifically, the Dertouzos/Wildman analysis demonstrated that the FCC's reliance on rates charged by cable systems in overbuild situations is misplaced and that the rates charged by those overbuild systems which were heavily represented in the FCC's so-called "competitive" sample of the industry do not represent truly "competitive" rates. This error, as well as mathematical errors, caused the FCC to miscalculate and overstate

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[1] Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, FCC 93-177 (released May 3, 1993).

[2] "Regulatory Benchmarks for Cable Rates: A Review of the FCC Methodology," attached to Viacom Petition for Reconsideration and Clarification (June 21, 1993).

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the effect of competition on rates. Accordingly, the benchmark rates are significantly lower than they should be and, in fact, in most instances do not compensate a cable operator for the costs incurred in running a cable system.

Viacom also explained that the FCC's decision did not provide for the recovery of "going forward" costs, especially those incurred by cable systems for system upgrades and programming. To remedy this, Viacom urged specific revisions to the rules governing "pass-throughs" to allow for capital improvements and increased programming expenses.

Viacom also demonstrated that cable operators must be permitted to compete with alternative video providers in offering services to multiple dwelling units ("MDUs") and institutional subscribers. Accordingly, it urged the FCC to apply its competitive necessity policy to cable so as to permit operators to negotiate fairly with the owners and managers of MDUs and have the flexibility to respond to competitive bidding for the provision of video services on a market-driven basis. Furthermore, the Petition explained the necessity and public benefits of allowing integrated systems serving the same geographic areas, but through numerous franchise jurisdictions, to advertise and charge customers of the system uniform rates.

## II. VIACOM'S ANALYSIS SHOWING SERIOUS FLAWS IN THE BENCHMARK METHODOLOGY IS UNREBUTTED

Significantly, no party has attempted to rebut the findings of the Dertouzos/Wildman analysis despite the fact that it undermines the methodological underpinings of the current benchmarks.

GTE in its pleading actually endorses and argues for the propriety of the numerous methodological problems demonstrated to exist in the Commission's benchmark analysis.[3] In its critique of the Dertouzos/Wildman study, GTE acknowledges that the overbuild systems upon which the FCC relied in its rate survey are not in fact representative of cable systems generally, but are typically bigger and technically diverse in their offerings. Consequently, as GTE also acknowledges, these systems can tap sources of unregulated revenue beyond those upon which other systems can rely. As far as GTE is concerned, these differences appropriately reflect competition and are desirable from the standpoint of the cable consumer. Thus, while GTE does not criticize the study's findings and agrees with its demonstration that the "overbuild" systems are not representative of the industry, it focuses on a single aspect of the study to argue that the thrust of the FCC's regulation nevertheless should force the rest of the industry to emulate these overbuilds.

GTE's contention misreads the Dertouzos/Wildman study and disregards numerous other flaws in the benchmark analysis which the study identified. The relevant point of the submission is that while the FCC was using these systems to replicate competitive effects, it was incorrectly assuming that the differences in prices between this "competitive" sample and the remainder of the industry was in fact a result of competition. As demonstrated by the study,

[3] GTE's Opposition to Petitions for Reconsideration at 8-9.

this direct relationship cannot be assumed and appears to be in error. Consequently, GTE's point is in error as its position is based on the same logical error as the Commission's.

Equally important, even if the FCC's assumption that the competitive differential is due to competition -- which it is not -- the benchmark analysis is still flawed in other regards. These errors, noted in the study, require the analysis to be redone.

## III. PROFIT MARGINS ON PROGRAMMING COSTS, REMOVAL OF LIMITS ON THE PASS-THROUGHS OF PROGRAMMING COSTS INCURRED BY CABLE OPERATORS AFFILIATED WITH PROGRAMMERS, AND PASS-THROUGHS OF CAPITAL INVESTMENTS IN SYSTEM UPGRADES ARE NECESSARY TO MAKE A BENCHMARK/PRICE CAP REGIME A REALISTIC OPTION FOR CABLE OPERATORS IN THE FUTURE

### A. Profit Margins on Programming Costs

Congress recognized that rate regulation could have an adverse ripple effect on programmers and suggested that the FCC develop pass-throughs to avoid unnecessary constraints on cable programming. In response, the Commission has properly provided for such pass-throughs. However, its approach is insufficient to address Congress' concerns because it permits operators to pass-through only a portion of the costs (i.e., the costs in excess of the GNP-PI) and receive no return on their investment in programming. This discourages not only a cable operator's expenditures on contract renewals for existing programming but also its investment in new programming.

A cable operator obviously will focus its resources in those areas where the greatest return is to be realized. Thus, unless an operator can earn a markup on its program investments as Viacom has proposed, it will be discouraged from investing in programming and will also seek to cut back on licensing fees currently paid to programmers. The ultimate losers are not only cable programmers, but most importantly, consumers who are adversely affected as the quality and diversity of programming diminishes.

B. Limitations on Pass-Through of Costs Incurred by Cable Operators Affiliated with Programmers

Under the rules, any cable operator with a five percent or greater interest in a programming service cannot pass-through cost increases above inflation where those costs are incurred for carriage of an affiliated program service. While acknowledging that programming cost increases often "far exceed" inflation, the FCC nevertheless imposed the limitation apparently due to a concern that a cable operator could inflate its intra-company costs for programming, pass-through the cost, and thereby circumvent the price cap regimen. The FCC could address any such abuse by prohibiting a pass-through of those increases for affiliated programming which exceed the average cost increase for the same programming to non-affiliated cable operators of comparable size.

C. System Up-Grades

Parties opposing allowing cable operators to pass-through the cost of system upgrades generally do so on the basis that either (a) cable operators are treated differently than regulated telephone companies, (b) system upgrade pass-throughs lead to "double dipping" because the benchmark rates purportedly already recover all costs incurred by a cable operator, including capital expenditures for system upgrades or (c) pass-throughs will result in upgrades which are not cost-justified. However, while the benchmarks presumably do reflect a recovery of past capital investment, they do not take into consideration the recovery of future investments. Viacom's showing that the GNP-PI constraint on external costs provides insufficient investment incentives is unrebutted and the FCC should allow the pass-through of costs incurred for rebuilds and expanding capacity.

Some local telephone companies oppose modification of pass-throughs because in their view the cable rate regulations must "parallel" regulations applicable to themselves and programming costs specifically, they assert, do not meet the definition of exogenous costs used by the FCC in the telephone price cap regulatory program. However, as Viacom has previously shown, such "parallel" regulation would contravene the plain language of the Act and ignore significant differences between the two industries.[4] Moreover, the telephone companies acknowledge that where differences exist between the FCC's common carrier and cable rate regimes, the latter is superior. Yet they would impose on cable the assertedly inferior regime. If telephone companies think features of the cable regulations should apply in their industry, their proper recourse is to file a petition for rulemaking, not try to handicap cable operators. Additionally, the telephone companies' arguments that investments by cable operators in system upgrades should not be treated as external because such costs are under management control is irrelevant. The argument does not take

[4] See Viacom International Inc.'s Opposition To Petition for Reconsideration of Bell Atlantic (July 21, 1993).

into account the substantial and unique policies in the Cable Act that, as Viacom's Petition explained, justify treatment of those costs as external.

Finally, concerns that pass-throughs might invite upgrades that are not cost-justified are unpersuasive. A company could be expected to "pad" its investments only when it is not likely to face competition or when it is insulated from the prospect of losing customers. However, the Commission has acknowledged that cable operators currently do have incentives to assure that their costs are not excessive since any excessive costs, if passed on in service rates, may cause an operator to lose subscribers.[5]

## IV. THE "COMPETITIVE NECESSITY" DOCTRINE SHOULD APPLY TO CABLE

Viacom's Petition demonstrated that applying the "competitive necessity" doctrine to cable promotes the public interest by ensuring that all distributors of multichannel programming can compete fairly and fully. Prohibiting a cable operator from bargaining in the marketplace to provide services to MDUs would not serve the FCC's objective of promoting competition. Indeed, if cable operators cannot freely negotiate, then consumers are disserved because a cable competitor would know that there is a price point below which it need not go in order to underprice the cable operator who, by FCC regulation, could not engage in negotiations which could result in yet lower prices for MDU subscribers.

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[5] Report and Order, ¶ 251.

MDU pricing flexibility predicated upon a legally and economically justified right to price a product competitively is a legitimate exception to any generally applicable uniform rate structure requirement which the Act may impose. It is also consistent with both FCC and Congressional intent to rely on competition, instead of regulation, to ensure reasonable cable rates and practices.

Furthermore, such pricing flexibility serves the public interest. As the competitors to cable have no non-discrimination obligations, they could offer to serve MDUs at rates that could not be met by cable systems. The loss of such significant subscribership over time will lead to increases in the rates to all cable subscribers. Maintaining these subscribers, therefore, will allow the cable system to charge everyone lower rates than otherwise it could. In this way, Viacom's proposal to apply the well-established "competitive necessity" doctrine would not grant operators unbridled pricing flexibility; it would, however, promote competition, which is in the public interest.

## V. CABLE OPERATORS SHOULD BE PERMITTED TO CHARGE AND ADVERTISE CONSISTENT SYSTEM-WIDE RATES WHERE A SYSTEM COVERS MULTIPLE FRANCHISE AREAS

Some local franchising authorities opposed Viacom's suggestion that cable operators charge and advertise a uniform, system-wide rate where a single system covers multiple franchise areas.[6] However, they offer no persuasive reason for their position.

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[6] See King County Opposition at 29; NATOA Opposition at 16-22.

The practical service and marketing difficulties imposed on a unified system under the current franchise-specific rule can be substantial. For example, under the current rules, Viacom's system serving the Puget Sound, Washington, area will be required to charge 71 different rates just for regulated services, many differing by mere pennies. This will seriously complicate Viacom's billing system and impair customer service, as its two centralized customer service centers will have to identify a customer's precise franchise area before even discussing price. Additionally, Viacom's computerized billing system must be revamped, and new computer programs and software written and developed, at great effort and expense merely to accommodate the many different computerized codes necessary to enable automated billing for 71 different jurisdictions, each with numerous rate combinations for regulated services, equipment, and unregulated services.

Viacom's advertising will also be disrupted. With generally no advertising media in the market consistent with franchise areas, Viacom will be unable as a practical matter to advertise price via radio, television, or newspaper, but will be able to do so, if at all, only through direct mail.

Since the pricing differential between franchises is merely a few cents per channel, Viacom submits that where a cable system serves multiple franchise areas, it should be allowed to charge a single, average common rate so long as the channel offerings remain the same for each area. Sound public policy recognizes that, absent extenuating circumstances, political boundaries should not require different treatment of consumers in one area as distinguished from those in the neighboring area. Accord 47 U.S.C. § 221(b) (1992). Not only has no "extenuating" reason been given, but no valid public policy reason at all has been offered why Viacom's proposal is not in the public interest.

VI. CONCLUSION

For the foregoing reasons, Viacom International Inc. respectfully urges the Commission to reconsider and clarify the portions of its Report and Order establishing rate regulation for cable operators as proposed in its Petition for Reconsideration and Clarification.

Respectfully submitted,

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August 4, 1993

## CERTIFICATE OF SERVICE

I, Phyllis C. Hall, a legal secretary at the law offices of Wiley, Rein & Fielding, do hereby certify that on this 4th day of August, 1993, I caused to be served a true copy of the foregoing "Viacom International Inc. Reply To Oppositions To Petition For Reconsideration" to be sent by U.S. first class mail, postage prepaid, to the parties on the attached service list.

Phyllis C. Hall

Phyllis C. Hall

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